

Queen's University

Course in Banking

LESSONS VII-IX

Corporation Finance

LESSON VII.—(Continued).

Questions for Review.

1. What are the chief sources of corporate funds?
2. Define the terms, investment, speculation, semi-investment, semi-speculation.
3. Give the substance of Sir Edmund Walker's address before the London Institute of Bankers.
4. What are the main sources of revenue from the investing public? To what extent do life insurance companies invest in bonds?
5. Why do corporations raise such a large proportion of their capital by issuing bonds?
6. Analyze the financial market from the investment point of view, showing what classes of buyers furnish funds to corporations?
7. To what extent should corporations use "short-time" loans? State the conclusions of Mr. H. V. Jones.
8. State the three opinions that prevail among financiers as to the proper basis of capitalization.
9. Give the essential elements of the mortgage bond.
10. What are the main types of corporation bonds?
11. Describe what is meant by senior and junior bonds.
12. How much reliance should be placed in the sinking fund by the ordinary corporation?
13. What is meant by the income bond? the collateral trust bond? participating bond? profit-sharing bond?
14. What are the chief reasons for the issue of bonds?
15. What are the main methods of redemption?

Questions for Written Answer.

16. Describe the difference between (a) bonds and stocks; (b) between the income bond and preferred stock.
17. Why is the debenture used to such an extent by English railways in raising funds? Why do Canadian and American railways issue such a wide variety of bonds?
18. Describe in detail (a) the collateral trust bond; (b) the equipment bond. Why are "serial" bonds favored at present by Canadian municipalities?
19. Bring up any difficulties.

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LESSON VIII.

Selling Securities on the Exchanges; the Disposition of Gross Earnings.

The stock exchanges furnish the best market for many corporate securities. On the principal exchanges of Canada—Toronto and Montreal—trading is carried on in a wide variety of domestic and foreign securities—industrial, transportation, mining, trust and loan, financial and others. In addition, Canadians carry on a large business on the New York exchange. In the United States there are several important exchanges in addition to that of New York. Boston is the chief market for stocks of copper-mining companies; Philadelphia specializes in Lehigh Valley, Pennsylvania and Reading; and Pittsburg in the securities of local steel companies and of the United States Steel Corporation.

Listing securities. As the New York exchange is the most important on this continent we may give a brief account of the methods of dealing in securities as practised there.

The exchanges, it may be observed, confine their members as far as trades on the floor are concerned, to a comparatively small number of approved securities. On the New York exchange all new securities must be investigated and approved before being "listed." The exchange has strict rules governing the admission of securities to the listed class. In the case of bonds, for example, a full statement of the terms under which they are issued must be submitted to the exchange investigating committee; a certified copy of the mortgage produced; proof that the mortgage has been properly recorded submitted; and a recommendation of the committee, that has all the force of an order, requires that corporations shall submit to their stockholders annual reports at least fifteen days prior to annual meetings. Investors and speculators quickly differentiated between the listed and the unlisted securities, and for their own advantage many corporations gradually placed their securities in the listed class.

The Curb Market. It was found, however, that there were a considerable number of corporations that were unwilling to furnish the detailed information required by the Stock Exchange committee. In addition there were many securities offered of a highly speculative nature—"cats and dogs" in Wall Street slang. All these securities are bought and sold in large numbers in the Wall Street district. This has given rise to an outside unorganized market known as the "Curb Market";

so called because the brokers meet in the open air in one of the streets near Wall Street. While anyone may go among these groups of brokers strangers would have little or no opportunity to carry on business. Several important stocks are dealt in in the Curb Market—among them, the securities of the former subsidiary companies of the Standard Oil and the American Tobacco Companies; those of the Baldwin Locomotive Works, of the Cluett-Peabody Company, the Goodrich Company and the Studebaker Company. Most of the other active stocks dealt in are those issued by mining companies. The Curb Market of New York also buys and sells "rights"—that is, rights to participate in new stock issues at exceptional prices granted to stockholders of record; and contracts for the purchase and delivery of stock not yet issued. Such stocks and bonds, in Wall Street parlance, are traded in "w.i.," which means "when issued."

Methods of operation on the Stock Exchange. The groups clustered in different places on the floor of the exchange or where the curb brokers meet apparently conduct their business in disorder and confusion. On the larger exchanges the brokers meet about "posts," the centre of the market for particular listed securities. There, with pad and pencil, the brokers carry on transactions involving many thousands of dollars—a mere sign signifying the conclusion of a bargain. It is needless to say that the terms of sale are kept with scrupulous accuracy by the members of the exchange. On a day of active business the floor resounds with the clamor and the din of bargain-making. Each broker makes his own notes, and at the close of the day the houses which they represent compare their respective accounts and settle balances through the Stock Exchange clearing house.

On a busy day as many as a million shares may be dealt in on the New York Exchange, representing perhaps \$100,000,000. Of course these shares are not bought outright and taken out of the market. The greater part of the buying and selling is purely speculative. What is bought and sold is the right to receive and the right to deliver certain stocks at the end of the day at the price fixed in the deals between brokers. In the majority of cases no actual delivery is made. Through the Stock Exchange, clearing house transactions in the same stock offset each other, and only balances are delivered by sellers to buyers. Many brokers balance sales by purchasers, hoping to "scalp" small profits of $\frac{1}{8}$ to $\frac{1}{4}$ per cent., and seldom see the actual stock certificates at all. Speculators acting in this way tend to steady prices. If they see stocks advancing they sell, hoping to realize their small profits. This principle applies to speculation in general. While brokers act in most cases for clients they also deal on their own account.

Not much business is carried on in Wall Street by way of actual investment; most buying and selling takes place "on margin."

Buying on margin. Most readers are familiar with the fact that marginal transactions are carried on with capital borrowed from the banks, the person for whom securities are bought or sold putting up little of his own money. Buying on margin may be illustrated as follows: The speculator buys 100 shares of stock selling at or near par (\$100); the broker in that case will demand \$10 per share or \$1,000. At the end of the day the brokerage house must pay for the shares \$10,000. The broker will put up the stock with his bank as collateral for a loan of say, \$8,000. It is plain that \$1,000 of the purchase price is still lacking, which the broker must himself furnish. Let us say the stock shortly advances 10 points and is sold. Out of the \$11,000 realized the broker pays the bank loan, reimburses himself \$1,000, and pays over to the speculator the balance, less interest and brokerage charges. If the stock, on the contrary, falls seven or eight points the speculator must put up additional margin or have the stock sold.

If the speculator chooses to sell on margin, or "sell short," he puts up \$1,000 as before and orders his broker to sell the same amount of stock. The broker effects the sale, and at the end of the day must deliver the stock. As no stock is owned it must be borrowed for this purpose. The stock is secured at the "loan corner" where securities are loaned to "shorts" on payment of the market price. If, within a short time, the stock goes down the speculator orders his broker to buy at the lower price; and this block of stock is given over to the lender. The speculator receives his \$1,000 and the margin of profit less brokerage charges. The brokerage house in this case receives interest on the money handed over to the lender of stock, and the speculator is thus relieved of interest charges. Of course if the stock goes up the speculator must put up more margin, else the broker, to protect himself, will buy stock and make delivery to the lender, returning to the speculator anything that may be left of his \$1,000.

How new securities find a market. To recapitulate what has been said: Only a comparatively few large corporations have their securities listed on the Stock Exchanges; but such securities as are listed have a splendid market, and are well advertised; and finally, the principal dealers on the exchanges buy and sell largely on speculative account.

When a new issue is listed on the exchange the process of selling it is largely the same as already described. The securities will be well advertised, an attractive prospectus will

be prepared, and the stocks or bonds listed on the exchanges. If, however, the issue is a large one, put out by a well-known corporation, the underwriting syndicate will endeavor to "make a market" for it. In other words they will endeavor to attract marginal speculators.

The speculator is constantly looking for a "tip," and thinks that general information furnished to everyone will bring little profit to himself. Therefore, rumors, "inside" information and so forth are sent forth broadcast. Especially is it important, from the point of view of the syndicate, to associate the names of strong "interests" with the security issue. An attempt is also made to line up the brokers in support of the issue. To that end, it must be seen that the banks will accept the stock as collateral. That is why such efforts are made to link up the banks with corporation interests. When all these points are attended to a market is generally found for the securities offered.

An important matter to consider further, however, is the price level of the securities so offered. In some cases the members of an underwriting syndicate are pledged to buy large blocks of securities if the price falls below a certain figure. When the price is so held up, speculators and investors are almost invariably attracted to the security issue.

Sometimes the stock is manipulated by means of "wash sales"—which means buying and selling by the same group of interested individuals. The practice is forbidden on the New York exchange, and brokers are not supposed to assist knowingly in such transactions. They are not expected to know, however, that a selling order given to them is matched by buying orders given to others. By such matched orders a manipulator can control the price of a stock at small expense—merely brokerage charges—unless other dealers enter the field. As the price advances and speculators are attracted the manipulator sells small blocks, always being careful not to alarm the market. The price does not advance steadily, but by jerks, as the manipulator must take care, above all, not to frighten away dealers by disclosing his operations.

There are three classes of dealers on the stock exchanges: capitalists who control corporations and large amounts of investment funds—bankers, brokers and corporation officials; men of means whose primary interests do not lie in Wall Street but who can afford to take a "flier" once in a while; and, third, the hangers-on, termed lambs, a class made up largely of professional men, unsuccessful business men and women who seek a short cut to fortune. In view of the fact that the work of the stock

exchanges is made a minute study by professional classes, the third group can not hope to succeed in their operation, being ignorant of fundamental market conditions and financial practice. This latter class would probably lose its money in any case; but however that may be the ordinary man who has no special knowledge of financial operations would be well advised to leave the stock exchanges alone.

Canadian stock exchange quotations. The range of stock and bond quotations in Canada for the past few years may be easily secured by consulting any annual financial review—such as those published by *The Toronto Globe*, or *The Monetary Times*. Readers should consult, for current quotations and interesting data, the financial papers published in this country, such as: *The Journal of Commerce*, Montreal; *The Financial Times*, Montreal; *The Financial Post*, Toronto; *The Monetary Times*, Toronto, etc. A great deal of interesting and valuable material may also be found in various financial reviews published by stock brokerage firms, which can be secured on application. The leading corporations should be examined with a view to familiarizing oneself with the names of the directors, the kinds of stocks and bonds issued, the rate of dividend paid, the market value of the securities outstanding, etc. Such data can be secured from the sources mentioned.

II. *The Disposition of Gross Earnings.*

Each corporation has its own method of stating its gross earnings from different sources and their distribution but the following may be accepted as a standard form:

- (a) Gross earnings from operation or manufacture.
- (b) Deduct operating or manufacturing expenses.
- (c) Net earnings from operation or manufacture.
- (d) Add income from other sources.
- (e) Total income.
- (f) Deduct taxes.
- (g) Balance applicable to fixed charges.
- (h) Deduct interest.
- (i) Deduct rentals.
- (j) Deduct sinking fund and other charges.
- (k) Balance applicable to dividends and surplus.
- (l) Deduct dividends.
- (m) Surplus from the year's operation.

All that is necessary to state in connection with the gross earnings is that they should be honestly stated. For example, when sales are made to persons whose credit is found to be

worthless it is useless to include such in the gross earnings. Again, the sales made by one company to another in the case of a holding concern manifestly should not be included in the total of earnings. In a word, nothing should be included in the statement that does not represent actual earnings by the corporation.

Operating expenses. Operating expenses should include not only the cost of raw materials, labor and current repairs but also a proper amount for depreciation. This last item is too often overlooked or disregarded by corporations, especially when replacing old machinery by new. In that case the cost is often charged up to capital account, although manifestly part, at least, should be charged to operating account. Railroad corporations in Canada and the United States as a rule carry over the cost of new equipment to the operating account and pay for such out of earnings. The English railroads, on the other hand, generally issue new securities to cover the cost of new equipment, and charge this item to capital account. It is quite evident that when worn-out equipment is replaced by new the company's assets have not been increased, but merely remains as before, unless the new equipment is more extensive than the old.

Depreciation, maintenance and repairs in manufacturing concerns are distributed between the plant as a whole and its departments, depending upon where the expenses have been incurred. The loss of value due to depreciation is undoubtedly the most difficult of all expenses to reduce to accurate figures, because there are so many elements to be taken into consideration. The general nature of the equipment, the length of service to be expected, the amount of use per day or month, the kind of business, the amount spent for repairs, and the likelihood of new methods and machinery being introduced, are the important factors to consider in determining the amount of the expenses that must be charged up each year to depreciation.

While we are concerned with the financial side of the corporation question only, and not with the problems of administration, it may be well to point out the two general methods followed in getting at the actual depreciation in a business, in terms of a money expression:

(1) According to the first method there are periodical revaluations of the property of the corporation, the difference between any two consecutive valuations representing the depreciation for that period. At first glance, this would appear to be an accurate method to follow; but practice has shown that such revaluation is at best an estimate which must be based on two factors, (a) condition of the plant, (b) earning power. The gain in accuracy, if any, is not enough to justify

the difficulty of making a revaluation of the property, except, perhaps, at long intervals.

(2) The second method is to estimate the life of a machine or building, and then write off a certain per cent. of its value each year, adding the same to operating expenses.

Two points should be kept in mind in writing off valuations according to the per cent. method. First, the estimates should be carefully reviewed from time to time, and errors corrected. It is considered good policy to charge a comparatively high rate, because it is better policy to place values where they belong rather than by charging the Profit and Loss account.

The second point to keep in mind is that the same per cent. can not be extended to cover complete groups. To be accurate each element of equipment must have its own depreciation rate.

There are three general causes of depreciation:

(1) Failure to keep property in first-class working condition.

(2) The gradual breaking down of property in spite of all that may be done to keep it in good condition.

(3) The most important factor of all—the unimpairment of the equipment because of new inventions and processes of manufacture.

It is difficult for one who is not brought in direct contact with the industrial world to realize the startling rapidity with which new tools, machinery, processes and appliances are invented. And each important discovery may necessitate a general revision of the whole equipment of a plant. The competitive struggle is intense, and the company that does not keep up with the march of invention cannot survive. The Americans have, on the whole, been the boldest pioneers in this line. The Carnegie Steel Company, for example, time after time sent to the scrap heap costly machines and even whole plants in order to adopt the latest and newest and most efficient methods of manufacturing. That this policy pays in the long run experience has amply proved. Therefore the amount on account of depreciation charged up to operating expenses each year should include not only provision for the decay of plant and machinery but for the replacement of old machinery by new, as well.

Unfortunately most corporations in Canada and the United States have not applied any scientific principles to the consideration of the element of depreciation. Manufacturers have made rough guesses only; and steam and electric roads have considered that the increasing value of their franchises more than offsets the loss due to depreciation. In the United States, however, the control over the accounts of interstate railways

exercised by the Interstate Commerce Commission has forced the railroads to make as accurate an estimate as possible of the annual depreciation of their property, and to set aside each year, as part of the expense of operation, an adequate depreciation charge.

The depreciation reserves, so called, are not sums set aside and invested outside of the property. They consist merely of the total charges against gross earnings over a number of years. These reserves are not separable from other capital funds invested in the business, except as a matter of accounting.

The item of depreciation, it will now be recognized, from what has been said, is a most important one. If a corporation charges up to capital account the cost of replacing worn-out equipment with new, a totally erroneous impression is given of the actual position of the corporation. Apart from the growing value of a franchise, etc., the assets of a corporation are bound to depreciate from year to year, and this loss should normally be made good by earnings. If it is not, high dividends may result from the actual distribution of the assets of the corporation, however that process may be disguised.

Income from other sources. Great care should be taken by directors to have the income from operating the business stated separately from the income from other sources, such as dividends and interest on the securities of subsidiary concerns, interest on bank deposits, rentals from property owned by the corporation but not used by itself, and so forth. Many such items are irregular and far from constant, and care should be taken to make these facts known.

Taxes, of course, must be deducted from gross income. There is a difference of opinion as to whether they should be regarded as fixed or variable expenses. As they fluctuate from year to year they should probably be considered as variable expenses, although the point is scarcely worth arguing about.

When all the above charges have been deducted the balance is available for dividends and surplus. We have explained elsewhere that preferred dividends may be cumulative or non-cumulative, the former often embarrassing the corporation managers, for such dividends, when passed, pile up at a very rapid rate and reach so large an amount that it may not be possible for years to pay anything on the common stock. In order to protect the common stockholders, therefore, it is desirable, if possible, to pay the cumulative preferred dividends

regularly; and lost ground should be made up at the first opportunity.

The payment of dividends. It is obvious that whatever is paid out in dividends results in a dead loss to the corporation, although it exists for that purpose. Because of this rather obvious fact there is often a conflict of interests between the directors of a corporation and the stockholders.

Some financiers are of the opinion that all the profits of the year belong to the stockholders and should be paid to them. The English corporations follow this practice, as a rule, and also many Canadian and American companies. There are two evident disadvantages in the practice, however; (1) it does not permit the corporation to build up a surplus of any considerable size; and (2) it makes the dividends irregular. For these reasons the Canadian banks do not pay all earnings to stockholders, preferring to build up a surplus even in excess of the legal requirements, and to pay a regular rate of dividend to stockholders.

Variability of profits. In all lines of finance and industry—in some more than others—the profits necessarily vary from year to year. This is true because the factors that enter into profits are themselves variable. These are:

- (1) Volume of business.
- (2) Prices obtained.
- (3) Price of raw materials.
- (4) Wages.

In no line of business can all these factors remain fixed from year to year, the greatest steadiness being found in public-service corporations and in those industries that produce the necessities of life. The farther the business gets away from these conditions the greater the fluctuations in some or all of the factors mentioned. A striking object lesson, and one that is familiar to every reader, is found in the variation in output, cost of material, etc., in most Canadian industries at the outbreak of war in Europe. Some of these facts are set forth in the following advertisement scattered broadcast in the Canadian press by the furniture manufacturers of Canada in an effort to secure normal conditions in their business:

Buy-a-Piece-of-Furniture

A slogan which should be as important to Canada as the "Buy-a-Bale-of-Cotton" movement was to the Southern States.

It is estimated that there are 800,000 farm households in Canada. Taken as a whole, our farmers are the most prosperous class of Canadians.

The war has enhanced the price of every bushel of grain and animal which they have to sell, while it has decreased the normal trade of their partners, the manufacturer and his workmen.

The home market is the most valuable one the farmer has or can obtain. Should unemployment set in for the urban industries and continue for any length of time, farm prices would drop after the close of the war, since their best customers would have lost their purchasing power and would not recover it for a long period thereafter.

The need of the day in this country is a realization that all suffer. Much can be done by co-operation—by having the big brother loosen his purse strings and buy manufactured articles which he needs for his family and household, but has deferred purchasing. Were each farm household in the Dominion to expend \$25 on necessities it would put \$20,000,000 into circulation at a critical juncture.

The furniture industry was hit harder by the war, perhaps, than any other branch of the country's business. Could the farm households of Canada be persuaded to expend \$25 each on useful articles, the furniture men should seek to have \$10 of it on an average spent on the products they make. It would mean from farm households alone orders for \$8,000,000 worth of furniture and ensure employment for 8,000 cabinet-makers for eight months if 1915.

Were the situation placed in a proper light, many others besides farmers would purchase a piece of furniture, and this industry would quickly recover lost ground.

The present generation will never again pass through a like time of stress, therefore it calls for unusual effort. The "Buy-a-Bale-of-Cotton" movement of the Southern States has succeeded in keeping the wolf from the door. On the face of it, one might well ask: What on earth can a man do with a bale of cotton? But Americans are buying them freely and doing an incalculable amount of good.

There is not a wife in the Dominion but would like another piece of furniture for her home. But she does not like to suggest its purchase now. Were the good they could do for an important industry and the workmen dependent upon it placed before them, they would buy the long desired piece of furniture for the dining-room, parlor or kitchen.

Faint hearts may say that there is the war rock in the way. Yet the Government reports state that \$1,000,000 worth of furniture was imported into Canada between April 1st and October 1st, 1914. A nation-wide "Buy-a-piece-of-Furniture" campaign would not only sell a heap of furniture but so advertise this class of Canadian-made products that it would increase its sales for years to come.

There is as much money in Canada as ever there was. It can be brought out of the national stocking by the right kind of appeal.

"Buy-a-piece-of-Furniture" is worthy of a big effort.

The important point emphasized in this advertisement, for our present purposes, is that even a slight increase in the demand may preserve an industry from bankruptcy, while a similar decline will wipe out profits altogether. Now—aside from wars and rumors of war—we know from experience that periods of prosperity and depression for the last fifty years have been regularly recurrent; and hence not even the most firmly established business can count upon the earnings of a stated amount of profits from year to year.

We may illustrate what has been said by submitting the financial statements of a number of Canadian corporations as follows:

Belding-Paul-Corticelli, Limited. The net profits of the Belding-Paul-Corticelli, Limited, for the year ended November 30th last, amounted to \$102,393, a decrease of \$25,483. After meeting debenture interest, sinking fund payments, and allowing depreciation charges of \$8,000, the company showed a surplus of \$42,283 or equal to 4.9 per cent. on the \$860,000 cumulative preferred stock

The profit and loss figures of 1913 and 1914 compare as follows:—

	1914.	1913.
Profit	\$102,393	\$127,867
Alloted as follows:—		
Debenture interest	\$ 37,220	\$ 37,409
Sinking fund	14,888	14,944
Depreciation	8,001	10,076
Written off		3,575
Dividends		29,904
	\$ 60,109	\$ 95,909
Balance	42,283	31,967
Previous balance	35,782	3,814
Total balance	\$ 78,065	\$ 35,782

National Breweries, Limited.—National Breweries, Limited's net trading profits for the year ended October 31, 1914, were \$493,823. This amount is lower by \$52,532 than the previous year.

A comparison of the profit and loss accounts of the company for the past two years is given in the following table:—

	1914.	1913.
Net profits	\$443,823	\$546,365
Bonds	1,30,000	120,000
Balance	\$373,823	\$426,355
Preferred dividend	194,250	194,250
Balance	\$179,573	\$232,105
Depreciation reserve	79,900	
Balance	\$ 99,673	\$232,105
Contingent Account	7,000	
Surplus	\$ 92,673	\$232,105
Previous Surplus	420,667	188,562
Total Surplus	\$513,346	\$420,667

Canadian Car and Foundry Company.—Combined profits of the Canadian Car and associated companies for the year ending September 30 last, were \$673,035, as against \$2,351,825 in the previous year, a decrease of upwards of 70 per cent. The \$673,035 is shown "after charging all expenditures for the maintenance and renewal of plant and equipment." Presumably the same course was followed a year ago. After providing in the present statement a sum of \$278,076 for depreciation and bond sinking funds, as against a total of \$349,166 under the same heads a year ago, there was a net balance available for bond interest of only \$894,958, as against \$2,002,158 in 1913, or a decrease of \$1,607,200.

The balance of \$394,958 was ample to pay interest on the company's own bonds, the outstanding issue of \$5,817,416 entailing a charge of less than \$350,000, but the statement now presented is a consolidated statement of Canadian Car and subsidiaries, and interest charges totalling for the year \$556,205, as against \$280,505 the previous year.

For 1914 the combined output of the associated companies was only \$11,000,000, as compared with \$27,000,000 the previous year, a reduction of 59 per cent.

Many other examples might be given, from every branch of Canadian industry, to show that stability of profits cannot be depended upon from year to year; but the reader can easily find other illustrations by consulting the financial journals of the country. The point that we should consider here is, To what extent, if at all, should directors follow the practice of paying to stockholders all the profits earned by corporations from year to year?

It is obvious that if the entire profits are given to the shareholders each year they will fluctuate, and, at times, fluctuate violently. Why not follow this policy, however, and let profits fluctuate as they do in partnerships and individual enterprises?

The answer is, that stockholders of the great corporations, at least, are not in close touch with business affairs. They want, not sudden increase of income, but a steady income. These people belong to the investment, not to the speculative, class. It is because of the demand of such investors for regular, dividend-paying securities, that such securities bring a high price in the market. In order to protect their credit, as well as for the reasons stated, corporations should endeavor to maintain a steady rate of dividend. In order to do so, the directors should pay out no greater dividends than can be maintained in lean years. Whatever is earned above that rate will go into the surplus fund. This may seem a harsh rule, for it keeps dividends low and cuts down the stockholders' income. But it works no injustice in the long run; for whatever is earned on surplus goes to increase the dividend rate. The policy, indeed, tends to give permanency and long-continued success to the corporation; features, surely, that are worth while, and whose advantages every stockholder should recognize.

We may sum up the points which should be emphasized as follows: (1) Directors should state gross earnings accurately, and should see that operating expenses are not understated; (2) they should set aside a sufficient amount to take care of repairs and depreciation; (3, they should meet all fixed expenses out of income; (4) they should pay cumulative preferred dividends, if at all possible, when due; and (5) they should resist the pressure of stockholders to pay larger dividends than would be warranted in the long run. A corporation whose directors will stand by these policies is to be congratulated, for only so will the stability and the prosperity of the company be preserved.

Questions for Review.

1. What is meant by "listed" securities? What advantages are derived from listing securities on the stock exchanges?
2. What is meant by the "curb" market? What kinds of securities are traded in on this market?
3. Why are no written contracts entered into on the floor of the exchanges? What forces compel the brokers to observe the terms of verbal transactions?

4. Explain in detail the methods followed in buying and selling "on margin."
5. What part do the banks play in furnishing funds for stock exchange transactions?
6. Name the three classes who operate on the exchange. What are the dangers the uninformed must face?
7. What are the differences between "bucket shop" transactions and those of the exchange?
8. What is the difference between "investment" and "speculative" securities?
9. How do manipulators prepare a market for new securities on the exchange?
10. What are "wash sales"? Why are brokers forbidden to participate in them?
11. How are gross earnings distributed among the various claimants?
12. What is meant by the "operating expenses"? What should be included in them?
13. What is the difference between "depreciation" and "betterment"? What are the practices of American and Canadian railroads, and English railroads, in connection with making provision for depreciation?
14. What are the two main rules for providing for depreciation?
15. What are the causes of depreciation? Should depreciation ever be carried to capital account?
16. How should "income from other sources" be treated in a corporation's statement?
17. What factors must be considered in estimating stability of profits?
18. How much of a corporation's earnings should be carried to "surplus?"

Questions requiring Written Answers.

18. Discuss the value of the stock exchange as providing a market for securities. What are the dangers of the stock exchange to the inexperienced investor?
19. What rules should directors of corporations follow with regard to the element of depreciation?
20. How would you justify the creation of large surplus accounts by corporations? Should all profits be distributed each year as dividends?
20. Bring up any difficulties.

LESSON IX.

Betterment Expenses; Management of the Surplus.

A betterment expenditure is one that results in raising the cost of a corporation's property. For example, when a railroad replaces wooden trestles with masonry embankments or steel structures, or light rails with heavy rails, or when it lines tunnels with brick or concrete, or fences its right of way, or treats its ties with some preservative, or elevates its tracks in cities, we have illustrations of betterment expenditures. When this higher standard has been reached it is the business of the Maintenance of Way Department to maintain it in the same manner as the lower standard which it succeeds. Betterments may be divided into two classes—(a) those which will likely increase the company's revenue; and (b) those which will bring no immediate return. An example of the first class is found in the buying of newer and more powerful locomotives by a railway company; an example of the second, is the replacement of old station buildings by new and more substantial ones. It is not always possible to find the dividing line, but the test is found in the immediate increase of earnings. A new station may not mean a greater volume of traffic or even a more economical handling of the old; but it may result in both in the long run.

Most accounting officials are of the opinion that betterment expenses should not appear as an increase in any asset account of the balance sheet. They may reduce the cost of operation; they may enable the company to handle a larger business; or to handle its existing business more economically. On the other hand, as has been pointed out, they may do no more than maintain the earnings of the company at the former level. A railroad company may have its rates reduced, and is always being forced by competition to improve its service. The improvements and economies, therefore, resulting from betterment expenditures may be no more than sufficient to offset the increased cost in operation due to higher wages, higher prices of raw materials, etc.

Former President Roberts, of the Pennsylvania Railroad, in analyzing the company's accounts, said of betterment expenditures: "The next item is that of extraordinary expenditure not properly chargeable to capital account, and is one to which attention has been drawn by our English stockholders. They charge that this is a capital expenditure and should not be charged against the current income. It is made up largely of moneys expended in straightening the line, in improving the

character of the stations, in providing additional track at various points, in changing iron bridges to stone, and wooden bridges to iron, and similar improvements that are not properly chargeable to capital account, because they do not actually increase the gross earnings of your property, but simply maintain it in a position to effectively and economically handle the traffic at the low rates shown in the report, and enable it to earn the interest on the money previously invested." On the other hand, some have just as strenuously held that betterments should be charged to capital account, especially when they result in an increase in earnings.

Securing capital for betterments. There are three main sources from which capital may be secured for betterments—surplus earnings, the investing public and the speculative public. The best method to provide for betterments is to draw the funds from earnings. Expansion may be slow by this expedient, but the growth of the corporation will be healthy and normal. A concern that finances its betterments in this way will expand along conservative lines. A striking illustration of a corporation that has been built up in this way is found in the growth of the Carnegie Steel Company. In 1871 when Andrew Carnegie and his associates with great difficulty got together a few thousand dollars and bought an insignificant steel-making plant no one could have realized the future growth of that business, built up as it has been by turning earnings back into the property. The business is worth to-day over \$500,000,000, and has been built up principally by putting the earnings into the business.

There are, of course, objections to this method. A more venturesome competitor may borrow the capital and capture the trade while the conservative firm is slowly making headway. Another, and perhaps more serious, objection is that stockholders are deprived of profits, in the early stages of the business. It is true that the shareholder has an increased value in the property, and that he may sell out to good advantage. Yet market values are based more largely upon earnings and dividends than they are upon underlying assets. For this reason stockholders as a rule will object to deferred dividends, which may be paid to others in years to come.

Aside from the fact that present dividends appeal to stockholders with greater power than future returns, even if much greater because deferred, the speculative stockholders desire a good market price for their stock and the chances of making a quick sale. They may think that dividends in the future will be cut, and that they can then repurchase at a lower price. This is one of the chief reasons why conservative directors should put the stock on an investment basis from the beginning.

When earnings are placed in the property in the form of betterments it is undeniable that the bondholders profit as a result because the value of the property has been protected or, perhaps, increased. This has great weight among the stockholders, and perhaps not without valid reason. For all these reasons, therefore, stockholders will object to paying heavy betterment expenses out of earnings. It often happens that directors who could not otherwise control the situation charge up betterments to operating expenses. This is a simple expedient, and it often works. The Lehigh Valley, for example, between the years 1898-1902, put \$13,000,000 back into the property under the head of "operating expenses" when, as a matter of fact, the new management installed in 1902 proved that the expenditure was for betterments. Nevertheless, the road was made a good one, in place of a poor one, and dividend payments as a result of this policy have been steady since. Yet the shareholders were not taken into the confidence of the directors, and it may be said that, however good the result achieved, they were deceived. Nevertheless, the financial practice is a splendid one, and might well be followed by conservative and careful directors.

Borrowing capital for betterments. We have already discussed the practice followed by many corporations of borrowing capital for betterments by issuing short-term notes. The dangers involved in carrying through such a policy have been pointed out in detail; hence it is not necessary to discuss the matter at length again. Obviously this method providing for betterments cannot be utilized unless the improvements yield large and immediate profits. Otherwise the corporation will be saddled with a fixed annual expenditure that must be met out of an insufficient income.

A much better method of securing funds for permanent betterments is the issue of long-time bonds. Most corporations of any considerable size do not intend to retire these debts when they fall due but rather to refund them by new bond issues. That is to say, they regard such bond issues as a permanent fixed charge on the earnings of the corporation. If the improvements yield a larger return than the annual bond interest calls for it is undoubtedly a wise financial policy to finance them by issuing long-term bonds.

One of the most successful corporations on this continent—the Pennsylvania Railroad—furnishes an admirable illustration of the principles enunciated. As already explained, this company separates all betterments into two classes: (a) those that will result in savings or profits more than sufficient to meet the interest on the capital invested; and (b) those that merely make it possible to secure more business and hence additional returns some time in the future. In the first class

are included such betterments as the straightening of the railway lines, cutting down grades, providing new equipment, etc.; in the second, the building of tunnels, new stations and so forth. All betterments of the first class are provided for by bond issues, while the second class is provided for out of surplus. In this way the stockholders receive the maximum of profits and the maximum of safety. The policy appears to be an ideal one and is being followed to a much greater extent than heretofore by corporations both in the United States and Canada.

Additional capital could, of course, be provided by the sale of stock instead of bonds; but the latter is a cheaper method of getting the necessary funds, for bonds can always be sold to better advantage than stocks bearing the same returns. On the other hand it is obvious that bonds increase the fixed charges and thus threaten the financial stability of the corporation. New stock issues, however, tend to reduce the rate of dividend that has been paid on the stock already outstanding. It may be said in conclusion, therefore, that as a general principle betterments of the first class ought to be financed either by bond issues, or, in exceptional cases, by short-term notes; while betterments of the second class should be met either by stock issues or out of the surplus earnings of the company.

In hardly any other way can a corporation so quickly imperil its financial security as by neglecting to properly take care of the items of depreciation and betterments. The directors should make themselves absolutely certain that the expenditures that are made from time to time should not be classed as betterments if the efficiency of the corporation is merely maintained at its former level. If expenditures are undertaken that result in no immediate increase of earnings the capital should be provided either from surplus or through stock issues. If, on the other hand, there is a permanent increase in the earnings of the company, betterments are best financed by the issue of bonds, preferably long-time in nature. All expenditures that make good depreciations should be financed out of annual earnings.

The Management of the Surplus.

Although much is said in current financial literature concerning the "surplus" there is a good deal of confusion in the minds of many business men concerning what a surplus is and

how it should be managed. As to the first point it may be said that the surplus consists of the difference between the assets and the obligations of a corporation, including in the latter all the outstanding stock of the corporation as well as its debts and reserves. Suppose, for example, the book valuation of the assets of a corporation is \$1,000,000; and that the liabilities consist of accounts payable, notes and bonds of \$500,000, depreciation and other reserves of \$50,000, and capital stock outstanding of \$250,000. It is evident that the corporation must have secured \$200,000 of its assets from some other source within its business. That source is called surplus. It appears on the liability side of the balance sheet because it is an amount for which the corporation must render an account.

The formation of the surplus. The surplus of a corporation may have been obtained in whole or in part by the selling of its securities above par. In that case the company receives a sum of money in excess of the obligations it must assume. Again, the surplus may have been secured by selling obsolete plants and machinery which have been already covered by a depreciation fund or reserve. Then the revaluation of the fixed assets of a corporation will show a gain, and this gain will manifest itself by an increase in the surplus account. Of course, as a rule, the upward revaluation of a company's property is not advisable, and is not in accordance with strict accounting or financial principles.

The most common form of building up a surplus, however, is through saving. We have already stated that after the fixed charges and reserves have been provided for the balance of the annual earnings of a corporation is available for dividends and surplus. The point has been emphasized, too, that a corporation should strive to maintain a policy of paying fixed dividends, and that if they are altered it should be only to increase them. Fluctuating dividends destroy the confidence of the investor and impair the credit of the corporation. It is wisest to estimate as accurately as possible the net earnings during the inevitable lean years, and to hold dividends at that level, carrying excess earnings to surplus. Of course, a stable rate of earnings makes unnecessary the creation of a large surplus.

Policy of the "trusts." Most industrial combinations or "trusts," especially in their earlier years, have been more anxious to pay dividends and so encourage the sale of stock than to build up a surplus reserve. Professor E. S. Meade, in his work "Trust Finance," has examined the policy in this respect of twenty-six important American consolidations. He finds that during the years 1898-1900 they earned \$150,201,390, and paid out about two-thirds by way of dividends. He says:

"This amount, although large in the aggregate, represents but little more than 3 per cent. per annum. It would appear, as already stated, that every consideration of prudence would incline the directors of these companies to reserve practically all their profits in order to strengthen the financial position of their companies. So far from following the path of prudence, however, 61.9 per cent—almost two thirds of these profits—were paid out in dividends, leaving 38.1 per cent. for the surplus reserve. The inadequacy of this reserve may be better understood when it is compared with the outstanding capital whose permanent values it was intended to secure. A reserve of only 4.2 per cent. is the net result of the operations of three years."

Both in Canada and the United States the results of such a policy are only too familiar among the industrial corporations. For a few years high dividends were paid and the stock sold at a high figure; but the inevitable reaction set in at the first slowing down of business. If the flow of capital from England to Canada is to be resumed after the war our industrial corporations must use every effort to preserve their credit. That means that in times of financial buoyancy corporations should build up reserve surpluses to meet the seasons of famine that are sure to come. In this connection it is worth repeating, perhaps, that readers should examine carefully the statements of leading corporations, to find out precisely what they have done in the past. A good deal of useful data may be secured, concerning the points we have dealt with, in the annual financial reviews of the *Toronto Globe*, the *Monetary Times* and other Canadian publications.

Methods of investing the surplus. One of the most important problems to consider in connection with the surplus is the manner in which it should be invested. It may be held or used in many different ways, among them as follows:

- (a) Cash.
- (b) Securities.
- (c) Decrease of current liabilities.
- (d) Sinking fund.
- (e) Increase of stock of raw or manufactured products.
- (f) Betterments.
- (g) Extensions and additions to fixed assets.

The surplus should be used to strengthen any weak spot in the corporation or to provide a fund for future emergencies. There are two conflicting opinions among financiers as to the proper use of the surplus. On the one side it is contended that the surplus should be merged with the rest of the corporation's capital funds; on the other, that it should be set aside as a sort of insurance fund to take care of future losses. The

advocates of the latter method argue that if the original funds are not sufficient to carry on the business properly they should be increased by issuing new stock or bonds, not by applying profits to the ordinary uses of the business. They insist that the true use of the surplus is to maintain dividends at a stable rate over a period of years, and for nothing else.

If this is the correct interpretation of the use to which the surplus should be put it is evident that it should be held in the form of cash or at least in the shape of liquid assets, such as securities. Of course the surplus may be placed in permanent assets on which loans can be raised if required; but the corporation can never be certain that loans can be raised to advantage at a time of crisis even on the best security. Moreover, as has been pointed out, it is not sound financial practice to base temporary loans on fixed assets. It may be said, therefore, that if the surplus is to be regarded as a fund held against future emergencies it should be maintained as a liquid reserve, either in cash or in easily marketable securities.

The English and German shipping companies afford examples of this method of dealing with surplus. The Cunard Company is said to have nearly one-third of its total assets invested in securities that have no connection with their business. Under severe competition earnings may decline, or bad trade conditions may bring about the same results. In such crises enough securities may be sold to maintain the regular rate of dividend. As is well known the Canadian banks have built up large surpluses also, which are held in a liquid form. Although stockholders have protested from time to time it can be said that the banks have adopted a sound financial policy in this regard. The advantages are so obvious in this case that it is not necessary to dwell upon them.

There are, however, so many disadvantages in following the policy that has been outlined that many corporations have rejected it. A cash surplus earns only a small return, perhaps three per cent. or a trifle more. This is an inadequate return on an industrial investment. If the surplus is invested in high-grade bonds the return also is very small, especially after taxes have been deducted. Moreover, the surplus, however invested, offers greater protection to the creditor of the corporation than to the stockholder. It is clear that the stockholder would be in a safer position if the surplus were turned over to him, and invested in securities on his own account.

Both in Canada and the United States the majority of the corporations put the surplus back into the property of the company. Sometimes the cash balance at the bank is increased thereby, if the corporation needs more money as a working

fund; sometimes the surplus is invested in part in the securities of corporations that the company wishes to control. In both cases the surplus is not regarded as a "rainy day" fund, but as a means of increasing business. It may be put into betterments or extensions, but whatever form it assumes the end in view is to increase the earning power of the business. It will depend, of course, upon the particular needs of each corporation as to how it will employ its surplus reserve.

Where the earnings of a business are particularly liable to fluctuate from year to year it is a wise policy to carry the earnings of good years to a surplus reserve fund and to hold that surplus as a liquid asset. Both the credit of a corporation and the prices it can obtain for its stock are affected by an irregular rate of dividend. When, however, the earnings of a corporation are fairly steady from year to year the surplus may be put back into the business. This at one and the same time increases the value of the stock and yields a larger return to the shareholder. In the end by a stock distribution or by some other method the increased value of the corporation's assets is divided among the stockholders. Thus the immediate return to the stockholder is increased and the division of the capitalized value of that return merely postponed.

Effects of surplus on assets and dividends. As already mentioned, when the surplus is put back in the business the value of the shareholder's assets is increased, and, as a result, he usually receives larger dividends. A point that should not be overlooked, too, is that this increase of assets, whatever form it assumes, makes for stability of dividends as well as for larger dividends. A relatively small surplus may bring about these desirable results. The corporation can extend its business and make up in one section of the country what it may lose in another through bad local trade conditions.

Then again, it would scarcely be possible for the individual to invest his earnings to the same advantage as the corporation can do for him. The Carnegie Steel Corporation made its stockholders wealthy by putting earnings back into the business and paying small dividends for a number of years. When the Carnegie Steel Corporation sold out its business in 1901 to the United States Steel Corporation then only was its enormous financial strength revealed. Almost \$500,000,000 in cash and saleable securities were distributed among the fortunate stockholders, and men found themselves made millionaires overnight.

Distribution of surplus through stock watering. We are not now concerned, however, with the final sale of the assets of a corporation but with the more usual methods of distributing the surplus. The first of these that should be noticed is the distribution of surplus through the declaration of a stock dividend. This is very often done in the case of public service corporations with a view to concealing large dividends. The stock capitalization is increased and the rate of dividend decreased, although the earnings on the capital invested remain the same as before. In effect this consists of the capitalization of the surplus and the distribution of that surplus to stockholders.

The reader may wonder what advantage is derived from such a transaction, aside from the concealment of earnings. The answer is that two shares of stock, paying 4 per cent., will, as a rule, sell for more on the exchanges than one share paying 8 per cent. This seems strange but it is borne out by experience. There are more people who are able and willing to buy the low-priced stock than the high-priced stock, and hence there is a broader market for the former security. This explains why the promoters of mining and oil and other highly speculative securities fix the par value of their shares at a low figure—\$10 or \$1 or even 10 cents and less.

Distribution of surplus through subscription privileges. As has been already said directors cannot issue stock, either in Canada or in most of the American states, at less than its par value, and regard it as fully paid. But there is no compulsion anywhere to issue stock at more than its par value. Now, the stocks of corporations that are paid a regular dividend of six or seven per cent., or more, sell at a higher figure than par. Directors take advantage of this situation and often distribute the surplus by giving stockholders the privilege of subscribing for new stock at less than the market price. This is frequently done when new capital is required for extensions or betterments.

Issuing stock at less than market price. It is plain that the surplus can be distributed by means of "privileged" subscriptions wherein, as has been said, the stockholder of record gets new stock below market value. Many railroad corporations, including the Canadian Pacific, have had recourse to this expedient, being able at one and the same time to distribute part of the surplus and to secure capital for betterments and extensions of the business. A corporation usually grants the right to stockholders to subscribe to the new stock issue in proportion to the shares held. Thus in 1902 the Illinois Central Railroad permitted stockholders to buy at par 20 shares of the new stock issue for every 100 shares formerly held. The

average price of the stock during the six months following the date of the new issue was 156 1/2, thus giving a large profit to those who bought the new stock.

Stockholders have four ways of realizing profits in such transactions:

(a) They may exercise their right to buy at the low price and sell later to their advantage.

(b) The stockholder may sell "short" when the new issue is announced and deliver later when he gets his share.

(c) He may sell an amount of his old holdings just equal to the number of shares he has a right to buy.

(d) He may sell his privilege or "right"—as it is called—to subscribe to the new stock.

The first method is the simplest, but sometimes it does not yield the best results. One loses the interest on his money so long as he holds the stock; and he may be forced to sell on a falling market. The reason for the latter is that an increase in the stock generally involves lessened security for all concerned. Moreover, once a "right" has been granted it is, as a rule, several years before another follows. And finally, the officials of a corporation, as well as the underwriters of the new issue, attempt to create a good market for the stock before it is issued, and the prices attained are seldom lasting. On the other hand, the stockholder who buys outright and sells at the first favorable opportunity is in an absolutely safe position.

This, however, cannot always be said of the "short" sale. In this case the stockholder through his broker sells "short" the same number of shares as he has the right to buy, putting up a 10 or 15 per cent. margin. The money received from the short sale is turned over to the broker to buy the new stock. All will go well provided the stockholder has not been caught in a bull movement of the stock or in a "corner"—the latter of which is very rare on the stock exchange or any other market. If, in a bull movement, he must deliver the stock before he gets his new shares, he stands to lose. He will lose more heavily, of course, if he has sold more than his quota of the new stock. Of course, if he has not tied up the old stock that he holds he can deliver that and avoid any serious loss; but very often such stock is pledged in some way and cannot be made immediately available.

The third method—the sale of the old stock—is not open to any of the objections stated. The stockholder is apt to get a good price for his old stock, and still retains the right to subscribe to the new; for the sale of part or all of the old stock will not impair the right to buy the new provided the

sale has not taken place before the day on which the rights are granted to all stockholders of record.

The sale of "rights" is the method used by those who do not wish to part with their old stock or to buy the new. When a corporation decides to give its shareholders of record a "subscription privilege" it is customary to send to each one a formal statement of the number of new shares to which he has a right to subscribe. Such documents may be transferred by endorsement and are themselves known as "rights." They are dealt in, of course, in the stock exchanges. As a rule the sale of "rights" does not yield the same returns as the actual sale of stock under the third method described above, for the reason that the market for "rights" is not as broad as that for the sale of stock. The demand for "rights" does not come, to any extent, from investors; because as a rule they do not understand how to estimate their value. Stock brokers and speculators looking for quick returns usually deal in rights; and as they are looking for bargains the rights do not, as a rule, sell for as much as they are actually worth.

The value of the right. It might be thought, at first glance, that the value of the right would equal the difference between the market price of the old stock and the price at which the new stock will be issued. This, however, is incorrect, as it does not take into consideration the effect of the new stock issue on the amount of stock outstanding. The new stock being issued at less than par does not bring into the corporation's treasury its proportionate amount of assets.

To illustrate concretely what has been said: The Illinois Central Railroad in August, 1902, increased its capital stock 20 per cent., and gave each five shares of the old stock the right to subscribe to one share of the new. The market price of the old stock was 170, and the premium was thus \$70 per share. Now each share of the old stock brought \$20 into the treasury, because it gave the shareholder of record the right to subscribe to one-fifth share of new stock at par for every share of the old stock held. For every \$100 of the old capital stock outstanding \$20 was to be added to the capitalization. After the new stock had been issued, therefore, each $1\frac{1}{5}$ shares should represent $\$170 + \$20$, and one share would equal $\$158\frac{1}{3}$; which would be the theoretical price of each share after the new stock issue. The value of the "right" attaching to each share of the old stock would then be one-fifth of $\$58\frac{1}{3}$. But as a matter of fact the average price of Illinois Central stock for the six months following August, 1902, was $152\frac{3}{5}$.

Concerning this point Mr. Lough says in his work, "Corporation Finance":—

"The following formula, commonly used on the New York Stock Exchange, gives theoretically the value of a right. Let P represent the premium on the old shares and R represent the percentage of increase (of the stock). Then the value of a right will be found by the formula

$$\frac{P \times R}{1 + R}$$

"Applying this formula to the Illinois Central example, we would have

$$\frac{70 \times .2}{1 + .2} = \frac{14}{1.2} = 11.66.$$

As has been stated these theoretical prices for "rights" are seldom attained because speculative purchasers of rights are not willing to go that high. Moreover, there are some assumptions underlying these mathematical formulae which may or may not be true. It is assumed, for example, that the stock market price of the old stock is a normal price uninfluenced by speculative factors. It is assumed, also, that the company's use of the funds which come to it from the sale of new stock will be neither more nor less remunerative than the use of the capital funds previously in its possession. It is assumed, moreover, that the market price after the new stock has been issued will be uninfluenced by speculative factors. There is a risk in all these assumptions, as the professional stock market trader well knows, and he is unwilling to pay the full theoretical price for the rights."

If the old rate of dividends is maintained on all the stock outstanding after new stock has been issued below the market price, the stockholder of record has been given, undoubtedly, a share of the surplus. The capitalization of the corporation has been increased without proportionately increasing the assets. This, of course, is 'stock watering'; but, after all, the stockholders are merely given a share of their own property. This is quite a different thing, let it be noted, from "overcapitalizing" the company. The latter consists in issuing securities, whether stocks or bonds, beyond the power of the corporation to pay interest or dividends thereon.

Questions for Review.

1. Explain the difference between "betterment" and "depreciation" expenditures.

2. Should betterment expenditures appear as an increase of assets in the balance sheet? Why or why not? State the policy of the Pennsylvania Railroad, in this respect.

3. From what sources is capital secured for betterments? What was the policy of the Carnegie Steel with respect to betterments?

4. When earnings are put back into the company in the form of betterments who profit most—bondholders or stockholders? Which class gets the added protection?

5. To what extent should capital be borrowed for betterments? What kind of securities should be sold for this purpose?

6. What are the advantages, if any, of selling stock to secure funds for betterments?

7. What is meant, precisely, by the term "surplus"?

8. How is the surplus generally secured by corporations?

9. What has been the usual policy of the "trusts" in Canada and the United States with respect to the paying of dividends and the creating of a surplus? What were the dangers involved in this policy?

10. What are the chief methods of investing the surplus?

11. Should the surplus be used to maintain dividends and for nothing else? If so, how should it be held?

12. Should the surplus be invested in the business of the corporation? What are the advantages of such a policy?

13. What bearing has the surplus on the assets and dividends of a corporation?

14. How is the surplus distributed among stockholders by stock-watering?

15. Describe in detail what is meant by "subscription privileges."

16. What is meant by stockholders' "rights"? How are such rights disposed of by stockholders?

Questions for Written Answers.

17. Illustrate by a concrete example how the theoretical value of a right may be determined. Why is the theoretical value of a right rarely the same as the market value?

18. How may a corporation best provide for betterments? From what sources should the funds for betterments be secured?

19. What are the usual methods of distributing the surplus? What value has a surplus to a corporation?

20. Bring up any difficulties.



